Fed Tapering – Is Another Tantrum on the Way? October 2021

OVERVIEW

- **Investors are fearful of a repeat of the 2013 Taper Tantrum when risk assets sold off.**
- **Current economic fundamentals, however, are quite different when compared with the pre-Taper Tantrum period.**
- **The Fed has opened the door to near-term tapering, which may already be priced into financial assets.**

Background

Since March 2020, the Fed's quantitative easing program, meant to stabilize the economy amidst the economic challenges of Covid-19, has supported markets through the purchase of Treasuries and mortgage-backed securities. While quantitative easing was just one component of the Fed's stimulus in 2020, its continued presence has drawn considerable attention as investors worry about a potential repeat of the 2013 Taper Tantrum. Uncertainty over the Fed's plans to end asset purchases has been a source of interest and concern for many investors. In this report, we take a new look at the Taper Tantrum of 2013 and compare the economic context of that period with current conditions.

Putting the 2013 Taper Tantrum into Context

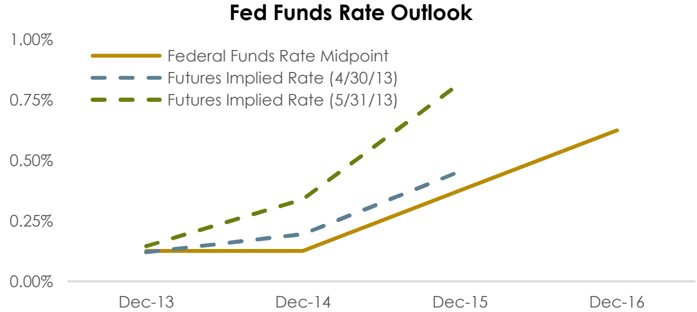
On May 22nd, 2013, FOMC Chair Ben Bernanke's comments in front of a congressional committee were interpreted by market participants as opening the door to tapering. Even without a full plan in place yet, the mere possibility of an end to Fed asset purchases disrupted the market, leading to negative returns in both equity and fixed income securities. Investment grade and high yield credit spreads peaked roughly a month later before drifting back toward prior levels. Despite short-term declines, the full calendar year of 2013 still saw a strong recovery for equities and some segments of fixed income.

	Largest Drawdown From May 22, 2013 - Dec. 31, 2013	Total Return for Calendar Year 2013
MSCI ACWI	-8.59%	23.44%
S&P 500	-5.58%	32.39%
US High Yield	-4.85%	7.44%
US Aggregate	-3.94%	-2.02%
US Treasury 3-5 Year	-2.49%	-0.96%
S&P Leveraged Loan	-0.93%	5.29%

Source: Bloomberg, ACG Research

Within fixed income, floating rate loans held up best in the initial movement amid the market's higher rate expectations. These expectations ended up overestimating the actual increase in the Fed Funds rate that would eventually be realized.

Fed Funds Rate Outlook



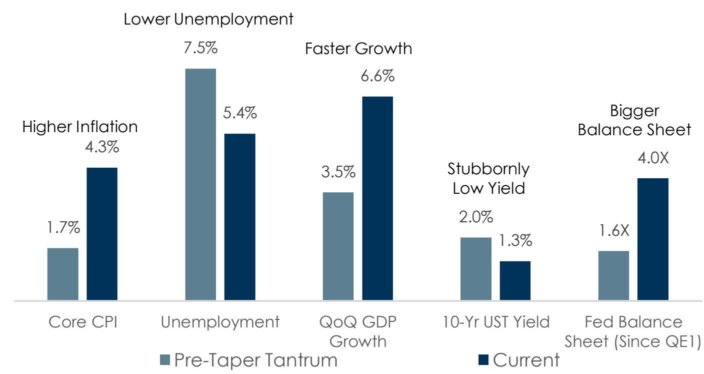
Source: Bloomberg, ACG Research

Rate-sensitive segments of the US Aggregate Index and intermediate to long-term US Treasuries ended 2013 in negative territory. Rising rates had a negative impact on total returns, with the 10-year US Treasury yield ending 2013 110 basis points higher than the day before Bernanke's congressional testimony.

Economic Conditions: 2013 versus Today

Relative to 2013, current economic conditions are on a stronger footing. Inflation is currently 4.3% vs 1.7% in May 2013, GDP growth is higher, and unemployment is lower than in the pre-Taper Tantrum period. With the 10-year Treasury yield running lower than in 2013 and the Fed balance sheet four times its year-end 2008 level, conditions appear more favorable for a reduction in monetary stimulus.

Current Conditions More Favorable for Tapering



Source: Bloomberg, Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve, ACG Research

The Surprise Factor is Gone

In 2013, the eventual rollback in quantitative easing was uncharted territory and the market responded to the discomforting uncertainty. Investors in 2021, with the benefit of previous experience, have a baseline with which to compare the current environment. We have arguably already entered into the most important part of the tapering process with the communication that tapering is on the way. Fed Chair Powell's recent Jackson Hole comments opened the door to a start to tapering that could begin this year, earlier than some market participants had predicted. Markets reacted favorably, perhaps reflecting Powell's comment that the future path of rate policy will be uncoupled from the timing of tapering. While we wait to see the exact details and timing of the Fed plan, market participants know to expect further news in coming months.

ACG's Position

We are cognizant of the irony that those risks with which the market is most concerned are often not the risks that induce the greatest losses. As the economic recovery continues to mature, some modest yield curve steepening can be expected. On balance, credit exposure is favored over duration.

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